Supreme Court, U.S.
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No. 09-1339

In The Supreme Court of the United States

NESTLÉ PURINA PETCARE COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether the Eighth Circuit, in agreement with the Third Circuit but in conflict with the Ninth Circuit, erred in holding that a deduction for dividends paid to withdrawing participants of an ESOP, as specifically authorized by §404(k) of the Internal Revenue Code, is nonetheless precluded by §162(k)(1), which disallows an otherwise allowable deduction "for any amount paid or incurred in connection with the redemption of [petitioner's] stock."

II. Whether this Court should clarify the deference owed by one circuit to the federal tax decisions of other circuits.

III. Whether the Eighth Circuit erred in holding that petitioner's deductions for "applicable dividends" paid under §404(k) were barred by §162(k)(1), where §162(k)(2)(A)(iii) expressly provides that the bar set forth in §162(k)(1) shall not apply to "deductions for dividends paid (within the meaning of Section 561)."

CORPORATE DISCLOSURE STATEMENT

Petitioner Nestlé Purina PetCare Company is a wholly-owned subsidiary of Nestlé Holdings, Inc., a Delaware corporation. Nestlé Holdings, Inc., is not a publicly traded company, and therefore no publicly held corporation owns 10% or more of petitioner's stock.

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PETITION FOR WRIT OF CERTIORARI

Petitioner Nestlé Purina PetCare Company respectfully requests that the Court grant a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals is reported at 594 F.3d 968 (8th Cir. 2010) and is reproduced in Appendix A (A-1). The opinion of the United States Tax Court is reported at 131 T.C. No. 4 (2009) and is reproduced in Appendix B (A-9).

JURISDICTION

The Tax Court had original jurisdiction over this case pursuant to 26 U.S.C. §§6213(a) and 7442. The Tax Court's final decision was entered on December 18, 2008, and petitioner's notice of appeal was timely filed on February 5, 2009. The United States Court of Appeals for the Eighth Circuit had jurisdiction under 26 U.S.C. §7482. Its opinion and judgment were filed on February 9, 2010. This Petition was filed within 90 days of that date. This Court has jurisdiction under 28 U.S.C. §1254(1).

STATUTES INVOLVED

The relevant portions of the statutes involved in this case are reproduced in Appendix C (A-44).

STATEMENT OF THE CASE

Formation and Funding of the ESOP

In 1989, petitioner created an Employee Stock Ownership Plan ("ESOP") component to its qualified retirement plan for its employees (Stip. ¶11).[1] The ESOP was created, among other reasons, to enhance the retirement income of Ralston's employees as well as providing them with an opportunity to own Ralston stock (Stip. ¶12). Employee participation in the ESOP was voluntary (Stip. ¶28). In almost every respect, Ralston's was a typical ESOP (Stip. ¶21) and did not contain any unusual provisions inserted for the purpose of generating the tax deductions at issue here.

In connection with the creation of the ESOP, Ralston authorized the issuance of new preferred stock, which was purchased and held solely by the ESOP (Stip. ¶¶42, 48(a), 50, 52, 53). To finance the purchase, the ESOP borrowed $500,000,000 from

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[1] Petitioner Nestlé Purina PetCare Company was known as Ralston Purina Company during the tax years in question and will be referred to here as "Ralston" to be consistent with the record and the opinions below.

various institutional lenders (Stip. ¶54).[2] Principal and interest due on the loan were paid by the ESOP with the proceeds of Ralston's contributions to the ESOP, contributions by employee-participants, and regular ("stated") dividends on the preferred stock (Stip. ¶58).

A separate ESOP account was maintained for each employee-participant (Stip. ¶32). Shares of preferred stock owned by the ESOP were initially held in a suspense account, but then were allocated to participants' accounts as principal was paid on the ESOP loan (Stip. ¶¶55-57).

Cashout Distributions to Terminated Participants

Upon termination of employment, the departing employee could no longer participate in the ESOP, and he or she was required to direct the ESOP to convert the shares of preferred stock allocated to his or her ESOP account into cash, shares of Ralston common stock, or a combination of both (Stip. ¶63). The ESOP had to provide this right to departing participants because the preferred stock was not readily tradable on an established securities market (Stip.

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[2] When the ESOP loan was paid in full in 1998, all shares of the preferred stock were converted into Ralston common stock. In December 2001, a Swiss corporation indirectly acquired all of Ralston's common stock resulting in the discontinuance of the ESOP component of the qualified retirement plan (Stip. ¶101).

¶¶23, 48(a), and §409(h)(1)). Additionally, the withdrawing participant needed to elect to either: (1) receive an immediate distribution in cash of the value of his or her ESOP account (a so-called "cashout distribution"); (2) receive an immediate distribution of Ralston common stock; (3) direct a rollover of his or her account balance to an individual retirement account or other qualified plan; or (4) utilize a variety of deferral options, including the receipt of an annuity (Stip. ¶¶65, 67).

ESOP Funding of Cashout Distributions

In accordance with the preferred stock's Certificate of Designation, the ESOP could, in its sole discretion, require Ralston to redeem shares of preferred stock when and to the extent necessary to provide, among other things, monies needed to fund cashout distributions to withdrawing participants (Stip. ¶¶48(l), 71). Such redemptions, though, were not a prerequisite to the ESOP's obligation to pay cashout distributions due to terminating participants; on the contrary, the ESOP retained the obligation to pay such cashout distributions even if Ralston did not redeem any of the ESOP's preferred stock (Stip. ¶75).

The ESOP could require Ralston to redeem preferred stock for the additional purposes of (a) satisfying a participant's investment elections (including requests for withdrawals or loans) or (b) paying principal and/or interest on the ESOP loan (Stip. ¶91). The ESOP was not required to use, and did not

always use, the amount realized from preferred stock redemptive dividends to pay cashout distributions to departing employees (Stip. ¶91).

The ESOP was not required to redeem shares of preferred stock equal in value to the value of shares of preferred stock allocated to a departing participant's ESOP account upon termination of employment to fund cashout distributions (Stip. ¶92). Rather, the ESOP had the discretion (which it exercised in some instances) to fund cashout distributions from otherwise available cash, such as employee contributions not necessary to make payments on the ESOP loan (Stip. ¶¶72, 92).

The Claimed Deductions

Sections 404(k)(1) and 404(k)(2)(A)(ii) provide that a corporation "shall be allowed as a deduction . . . the amount of any applicable dividend paid in cash . . . with respect to applicable employer securities . . . which . . . is paid to the plan and is distributed in cash to participants in the plan . . . not later than 90 days after the close of the plan year. . . . " During its tax years ending September 30, 1994, and September 30, 1995, Ralston redeemed, at the ESOP's request, approximately $9.4 million of preferred stock (Stip. ¶¶78, 82). Respondent ("Commissioner" or "government") does not contest that these redemptions (referred to as "redemptive dividends") were essentially equivalent to dividends within the meaning of §302(b)(1) and, therefore, treated as dividends for

purposes of §§301 and 316 (Stip. ¶93). The ESOP distributed these proceeds to withdrawing participants as cashout distributions within the time frame required by §404(k) (Stip. ¶¶80-81, 85-86). The ESOP funded additional cashout distributions during the 1994 and 1995 tax years in the amount of approximately $1.6 million and $1.1 million, respectively, from otherwise available cash (Stip. ¶¶81, 86). *Id.*

Ralston claimed a deduction under §404(k) for the applicable dividends – *i.e.*, the amounts distributed by the ESOP as cashout distributions that were funded by the redemptive dividends. Ralston did not claim a deduction for cashout distributions that were not funded by redemptive dividends (Stip. ¶¶81, 86).

Tax Court Proceedings

This case was initiated when Ralston filed its petition with the Tax Court for redetermination of the notice of deficiency issued by the Commissioner concerning adjustments not relevant here. Jurisdiction was based on 26 U.S.C. §§6213(b) and 7442. While the case was still pending in the Tax Court, the Ninth Circuit in *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), affirmed an Idaho District Court determination that the same type of "applicable dividends" at issue here were deductible under §404(k). The Ninth Circuit also held that such deductions were not barred by §162(k)(1), which prevents a corporation from deducting "any amount paid or incurred by a corporation in connection with the

redemption of its stock." Consequently, Ralston requested and, with the consent of the Commissioner, received permission to amend its Tax Court petition to claim deductions for applicable dividends under §404(k).

Ralston and the government settled all issues in Ralston's Tax Court petition except for the applicable dividend issue. The facts were fully stipulated, and on cross-motions for summary judgment, the Tax Court, in an opinion filed on September 10, 2008, determined as a matter of law that deductions for applicable dividends funded by the proceeds of redemptive dividends were barred by §162(k)(1) (A-9). The basis for this decision was the Tax Court's declaration, *sua sponte*, that the redemptions of preferred stock were "statutorily integrated" (A-28) – a term not found in any tax case ever reported and a legal conclusion never urged by the Commissioner – with the cashout distributions. In addition, the Tax Court rejected, without any analysis whatever, Ralston's argument that the exception to §162(k)(1) provided by §162(k)(2)(A)(iii) – *i.e.*, for amounts paid which constitute a "deduction for dividends paid" – was applicable and permitted the claimed deductions (A-20). The Tax Court entered its final Decision on December 18, 2008 (A-41), and Ralston filed its notice of appeal to the Eighth Circuit on February 5, 2009.

The *General Mills* Case

On January 26, 2009, a panel of the Eighth Circuit in *General Mills, Inc. & Subsidiaries v. United States*, 554 F.3d 727 (8th Cir. 2009) (*"GMI"*), reversed a decision of the United States District Court for the District of Minnesota, and concluded that deductions for applicable dividends funded by the proceeds of redemptive dividends were barred by §162(k)(1).[3] In its decision, the court openly disagreed with *Boise Cascade*, cited the very recent Ralston Tax Court decision referring to "two connected steps," and summarily held that §404(k) itself "creates a nexus between the [cashout distributions] and the stock redemption" – a paraphrase of the Tax Court's "statutory integration" theory. *Id.* at 729-30. The panel also found "irrelevant" various facts relied upon by the Minnesota district court demonstrating that the redemptive dividends and cashout distributions were factually separate and distinct. *Id.* at 730. Because the Tax Court opinion in this case was handed down after the briefing in *GMI* was completed, neither party in *GMI* had an opportunity to brief the issues raised by that opinion.

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[3] Because of its relevance to the issues presented by this case, the *GMI* opinion is reproduced in Appendix D (A-50) for the Court's convenience.

The *Conopco* Case

The Third Circuit on July 13, 2009, followed the *GMI* rationale in *Conopco, Inc. v. United States*, 572 F.3d 162 (3d Cir. 2009), in affirming a district court judgment that had disallowed a deduction under §404(k) based on reasoning that was rejected by *Boise Cascade*, *GMI*, and the Tax Court in this case.[4]

Proceedings Below

By the time Ralston's case was submitted to the Eighth Circuit on December 15, 2009, the *GMI* decision was already on the books, and the Ralston panel held that it was bound by the law-of-the-Circuit rule to reject Ralston's position on the §162(k)(1) issue (A-4). The court refused Ralston's request to reconsider *GMI* and did not even discuss Ralston's challenge to the Tax Court's opinion or its refusal to follow *Boise Cascade*. The court also ruled that the exception to §162(k)(1) contained in §162(k)(2)(A)(iii) for "any deduction for dividends paid (within the meaning of Section 561)" did not apply.[5] Although §561 merely defines (circularly) a deduction for dividends paid to include dividends paid during the taxable year, the court relied on the fact that §162(k)(2)(A)(iii) permits a deduction for dividends

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[4] Neither General Mills nor Conopco sought review by this Court.

[5] This second issue was not presented in either *GMI* or *Conopco*.

paid "within the meaning of Section 561" and does not say "within the meaning of §404(k)" (A-6). It also noted that a Treasury Regulation, §1.561-1(a), without purporting to be exclusive, listed five sections as to which the deduction for dividends paid was applicable, but did not mention §404(k) (A-6).

Although the parties stipulated that the dividends at issue were indeed dividends under §316 (and therefore were "dividends" for purposes of §561), the court relied on the legislative history to conclude that the "true meaning" of the plain language of the statute was not intended to include this particular type of "dividend paid" (A-7).[6]

REASONS FOR GRANTING THE PETITION

This Court should grant certiorari to resolve a stark conflict between the Ninth Circuit, on the one hand, and the Eighth and Third Circuits, on the other, involving an important provision of the Internal Revenue Code. The decision below contravenes the Congressional purpose of encouraging ESOPs by providing deductions to employers for cashout distributions funded by redemptive dividends. And the court's construction of §162(k)(2)(A)(iii) misconstrues the plain, unqualified term "dividends paid" to exclude §404(k) dividends paid, without any statutory

[6] Both the *GMI* opinion and the decision below in this case were authored by Circuit Judge Duane Benton.

support for such a limitation. This Court's intervention is therefore needed to provide uniformity in the application of these federal statutes that affect millions of ESOP participants.

I. CERTIORARI SHOULD BE GRANTED TO RESOLVE THE CIRCUIT SPLIT REGARDING THE IMPORTANT ISSUE OF THE DEDUCTIBILITY OF "APPLICABLE DIVIDENDS" UNDER §404(k).

A. The Statutory Scheme

As noted previously, §§404(k)(1) and 404(k)(2)(A)(ii) provide that a corporation "shall be allowed as a deduction . . . the amount of any applicable dividend paid in cash . . . with respect to applicable employer securities . . . which . . . is paid to the plan and is distributed in cash to participants in the plan . . . not later than 90 days after the close of the plan year. . . ."[7] The court in *GMI* did not dispute that the provisions of this section were met, and the Tax Court assumed they were (A-19). Ralston paid its ESOP certain sums to redeem preferred stock held by the ESOP. The government did not contest that these redemptions are dividends for tax purposes (Stip. ¶93) and thus are called "redemptive dividends." In some cases, the ESOP thereafter used some or all of the proceeds of redemptive dividends to satisfy cashout

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[7] The relevant text of the statutory provisions at issue in this case is set forth in Appendix C beginning at A-44.

distributions due to terminated participants. To the extent that such cashout distributions were paid to those departing employees not later than 90 days after the end of the ESOP's plan year, Ralston claimed a deduction for "applicable dividends" as specifically authorized by §404(k).

The Commissioner disallowed the deductions by primary reliance on §162(k)(1), which provides " . . . no deduction otherwise allowable shall be allowed under this chapter for any amount incurred by a corporation in connection with the redemption of its stock." Although admittedly broader, §162(k)(1) was added to the Internal Revenue Code mainly to preclude corporations from claiming a deduction for "greenmail" payments made to repurchase stock from corporate raiders threatening a hostile takeover. *See* H.R. Rep. No. 99-426, 99th Cong. 1st Sess. at 248 (1985). Most importantly, the legislative history clarifies that §162(k)(1) is intended to bar deductions for two types of expenses: (1) the consideration paid to repurchase stock, and (2) expenditures which are "necessary or incident" to the repurchase. *See* Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 278 (Comm. Print 1987).

B. Section 404(k) Requires Two Transactions for There To Be a Deduction.

As is evident from the plain language of §404(k), the deduction for dividends paid does not arise solely

on account of the redemptive dividend – *i.e.*, there must be both a redemptive dividend and a cashout distribution. The government has acknowledged that two transactions are necessary for an "applicable dividend" under §404(k) (Gov't 8th Cir. Br. in *GMI*, p. 42), and that the §404(k) deduction is determined by the amount, timing, and use of the cashout distribution.[8]

Indeed, the parties' stipulation shows that the payment of redemptive dividends by Ralston was not a prerequisite to the obligation of the ESOP to make cashout distributions (Stip. ¶75). The ESOP was required to make cashout distributions to terminated participants even if Ralston did not redeem any of the ESOP's stock.[9] On the other hand, the ESOP could force Ralston to redeem stock for various other reasons and was not required to use, and did not always

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[8] For example, the 1994 redemptions generated $3,128,066 in proceeds to the ESOP, but only $2,317,656 was distributed to terminated participants as cashout distributions during the 1994 tax year (Stip. ¶¶78, 80). Hence, Ralston's claimed deduction for 1994 was limited to $2,317,656 (Stip. ¶80). Because the remaining $810,410 was distributed by the ESOP during the 1995 tax year (but within the time limit set forth by §404(k)), this amount was deducted on the 1995 return (Stip. ¶81). The ESOP also funded cashout distributions in the amount of approximately $1.6 million in the 1994 tax year, but because those distributions were not funded by redemptive dividends, no deduction was claimed under §404(k) or any other Code provision (Stip. ¶81).

[9] In fact, prior to 1994, there were no redemptions of preferred stock even though the ESOP made cashout distributions to many terminated participants (Stip. ¶77).

use, the proceeds of the redemptive dividends to fund cashout distributions (Stip. ¶¶71, 91, 92).

The *GMI* court seriously erred in refusing to consider whether these factors prevented the cashout distributions from being paid "in connection with" Ralston's redemption of the ESOP's stock – the essential inquiry under §162(k)(1). The court's labeling of these factors as "irrelevant" is bewildering because they are so obviously central to the consideration of whether the redemptive dividends and the cashout distributions should be considered separate or unitary. The stipulated facts plainly established that for purposes of §162(k)(1) there was no *necessary* connection between the two transactions and that the deduction for applicable dividends should have been allowed. Instead of affording Ralston the opportunity to explain the court's mistakes in *GMI*, the Eighth Circuit compounded its error by blindly adhering to *GMI* without addressing Ralston's challenges to the rationale of that opinion.

C. The Cashout Distributions Were Not Made "In Connection With" the Redemptive Dividends.

The Commissioner admitted below that a cashout distribution was required for the deduction of an "applicable dividend" but argued that the cashout distribution was made "in connection with" Ralston's redemption of the ESOP's stock and for that reason was barred by §162(k)(1). In *Boise Cascade*, though,

the Ninth Circuit correctly observed that "we are confronted with two segregable transactions: the stock redemption by Boise Cascade and subsequent distribution to the Plan Participants by the Trustee. The two are not ineluctably linked. In fact, the transactions were entirely separate." 329 F.3d at 757.

The *Boise Cascade* court addressed the "in connection with" language of §162(k)(1) and emphasized the legislative history showing that this provision "was not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time and arising out of the same general circumstances." *Id.* The court observed that the "triggering event for the Trustee's duty to distribute payments is the election of the Participant, not the redemption of the stock." *Id.* at 758. Therefore, the distribution by the ESOP to the terminated participant is a separate transaction that is not "in connection with" a redemption of the taxpayer's stock and, as a result, the deduction is not barred by §162(k)(1). *Id.*

The Ninth Circuit bolstered its conclusion by legislative history confirming that expenditures deemed to be "in connection with" a stock redemption are those that are (1) for the consideration paid to redeem the stock, or (2) expenses "necessary or incident" to the repurchase, such as legal, accounting, and brokerage fees which facilitate the redemption. *Id.* Since Boise Cascade was not claiming a deduction for the consideration paid to redeem the stock, and because

the cashout distribution was not "necessary or incident" to the redemptive dividend, it was not made "in connection with" the redemption, and deductibility was not barred by §162(k)(1).

The Ninth Circuit's analysis was correct and should have resulted in a judgment for Ralston. The Tax Court, however, concocted a new theory of tax law, *sua sponte*, by declaring that the two admittedly separate transactions are "statutorily integrated" – whatever that means. Nowhere in the countless volumes of Article I and Article III tax law decisions had such a term ever before been deployed. The court said that because two transactions are required to satisfy the elements of §404(k), they must be deemed "statutorily integrated" for purposes of §162(k)(1) and therefore are "in connection with" each other as a matter of law (A-21-22). Never in the lengthy history of these various cases had the government ever advanced such a "statutory integration" theory – not even in *GMI*, where it was nevertheless adopted by the Eighth Circuit on its own initiative. And the appellate court deemed the issue foreclosed by the time Ralston's appeal ripened.

The "statutory integration" theory, however articulated, is wrong as a matter of linguistics and of law and defies legislative history. The dictionary defines "integrate" as "to unite with something else." *Webster's Ninth New Collegiate Dictionary*, p. 628 (1988). Indeed, we commonly think of "integration" as the blending together of the races, a process whereby they are literally commingled. By no measure is the

redemptive dividend "united with" or "mixed with" the cashout distribution. They are, as *Boise Cascade* held, "entirely separate" transactions. The government, too, has consistently acknowledged that the two events are required for a deduction under §404(k) and has urged that the "correct analysis" is a "bifurcated" one in which this Court should look "at one or the other of the two [transactions] separately . . . " (Gov't 8th Cir. Br. in *GMI*, p. 42). The Tax Court and the *GMI* court, however, ignored the plain meaning of "integration" and simply held that because §404(k) requires two transactions to qualify for the deduction as a matter of fact, those two separate occurrences should be deemed unified *as a matter of law* under §162(k)(1). That conclusion cannot withstand scrutiny but was imposed upon Ralston by the Court of Appeals without independent consideration.

The rationale deemed dispositive below also contravenes existing tax jurisprudence, as the "statutory integration" pronouncement is inconsistent with the concept of integration in other tax cases. This issue was never briefed in the Tax Court or in *GMI*, and the Court of Appeals in this case refused to consider ample authority holding that two formally separate transactions involving the same funds without any restriction on the receiving party as to their disposition (as in the case of the Ralston ESOP) should not be treated as integrated. *See Wilgard Realty Co. v. Commissioner*, 127 F.2d 514, 516 (2d Cir. 1942) (acquisition and disposition of property are separate transactions even if pursuant to preconceived plan of

disposition not amounting to binding obligation); *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971) (trust's receipt and subsequent disposition of assets considered separate transactions); *Kass v. Commissioner*, 60 T.C. 218, 226 (1973) (recognizing "the *truism* that the step-transaction doctrine, even when worded consistently . . . and applied to identical facts, *may result in integration in one case and 'separateness' in another case simply because the legal question to be answered has changed*") (emphasis added); *see also King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct.Cl. 1969). ("It has been persuasively suggested that the aphorisms about 'closely related steps' and 'integrated transactions' may have different meanings in different contexts, and that there may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied.").

Moreover, no matter how the redemptive dividends and cashout distributions are denominated for purposes of §404(k), that does not mean that the cashout distributions are "in connection with" the redemptive dividends as required to bar a deduction under §162(k)(1). Sections 162(k)(1) and 404(k) have different language, purposes, and legislative histories. Section 404(k) authorizes a deduction if the ESOP timely distributes the proceeds of a redemptive dividend. There is no requirement that the redemptive dividend and the distribution be factually "connected" or "integrated" or that the distribution be "necessary or incident" to the dividend. They might

occur in different tax years, could be separated by as much as 15 months, and, in fact, are initiated and received by different parties (redemptive dividends by the ESOP and cashout distributions by terminating participants).

The legislative history refutes the notion that payments made to departing ESOP participants should be considered to be "in connection with" the redemption of Ralston's stock:

> "Congress intended that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal and similar fees incurred in connection with the repurchase; and any other expenditure that is *necessary or incident to* the repurchase. . . . " Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 278 (Comm. Print 1987) (emphasis added).

Likewise, Congress emphasized that the phrase "in connection with" a repurchase

> "is not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time and arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under

> an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision." H.R. Conf. Rep. 99-841, 1986 U.S.C.C.A.N. 4075, 4256-57.[10]

There are numerous cases that have explored the breadth of the deductions barred by §162(k)(1). In each instance, the courts have disallowed a deduction only for expenditures "necessary or incident" to the redemption. *See, e.g., Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 361-62 (1994), *supplemented by* 107 T.C. 187 (1996) (barring a deduction for costs and fees incurred by a taxpayer to obtain debt used to redeem stock because the loans were "absolutely necessary to the redemption" and arose "solely because of the redemption"); *Custom Chrome, Inc. v. Commissioner*, T.C. Memo 1998-317 (disallowing a deduction for legal and professional fees paid to effect a leveraged buyout because such fees were "necessary or incidental to the redemption"), *rev'd in part on other grounds*, 217 F.3d 1117, 1126-27 (9th Cir. 2000). In *Chief Industries v. Commissioner*, T.C. Memo 2004-45, the court noted that the *Fort Howard* decision rejected a deduction for the financing expenses because the redemption "would not have been

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[10] As with the example in the legislative history, we are faced here with the deductibility of a compensatory payment (*i.e.*, a cashout distribution) made to a departing employee. The two hypothetical transactions in the Conference Report are considerably more "connected" than those in the present case; yet Congress decreed that the deduction be allowed.

possible without the financing" and that the "financing was 'necessary' to the transaction as a whole and was '*an integral part*' of a detailed plan." In short, each of these decisions disallowed a deduction only for expenses which were necessary to facilitate the redemption. The Eighth Circuit has substantially expanded the sweep of §162(k)(1) in a manner at odds with this line of cases.

Consistent with the authorities under §162(k)(1), the language "in connection with" has likewise been interpreted in other contexts to mean "to facilitate." For example, the phrase "used or possessed any firearm or ammunition *in connection with* another felony offense" in the Sentencing Guidelines is construed to mean that the firearm "must facilitate, or have the potential of facilitating, the drug trafficking offense." *United States v. Martinez*, 258 F.3d 760, 762 (8th Cir. 2001), citing *United States v. Regans*, 125 F.3d 685, 686 (8th Cir. 1977). And this Court has recently interpreted "facilitate" as synonymous with "aid" or "abet." *Abuelhawa v. United States*, 129 S.Ct. 2102, 2106 (2009).

The government has never asserted, and the record does not show, that the cashout distributions to terminated participants by the ESOP "facilitated" the redemption of preferred stock. Manifestly, they were not "necessary or incident" to those redemptions within the intendment of Congress.

* * *

Congress authorized ESOPs as vehicles to create widespread access to capital ownership and, in so doing, encouraged companies to make substantial payouts from earnings to "put purchasing power into consumers' hands." 129 Cong. Rec. 33815 (1983). To further this goal, Congress expressly authorized "a tax deduction to ESOP companies for the amount of cash dividends that they pay on stock in their ESOP, provided that the dividends are . . . distributed currently to employees. . . . " 129 Cong. Rec. 33826 (1983). The incentive provided by the §404(k) deduction helped to fuel dramatic growth in the creation of ESOPs by employers. Since 1974, the number of ESOPs has grown from about 200 to more than 11,000 at the end of 2005 (Stip. ¶14). These ESOPs own assets worth approximately $600 billion and have nearly 10,000,000 employee participants, representing 10% of the entire private sector workforce (Stip. ¶¶14-15). The significance of the decision below is thus apparent.

In enacting the Tax Reform Act of 1976, which provided substantial tax incentives to employers to create ESOPs, Congress specifically expressed "deep concern[ ]" that the objectives of the legislation not be made unattainable by restrictive regulations and rulings. *See* Pub. L. 94-455 §803(h), 90 Stat. 1520, 1590 (1976). The court below has done exactly that through a feat of judicial alchemy by transmuting two transactions into one, and has unnecessarily created a conflict with the better-reasoned decision of the Ninth

Circuit in *Boise Cascade*, which is also more faithful to the legislative wish.[11]

II. THIS COURT SHOULD CLARIFY THE DEFERENCE OWED BY EACH CIRCUIT TO THE FEDERAL TAX DECISIONS BY OTHER CIRCUITS AND SHOULD HOLD THAT THE EIGHTH CIRCUIT WAS REQUIRED TO FOLLOW THE DECISION OF THE NINTH CIRCUIT ON THE SAME ISSUE TO PROMOTE CONSISTENCY AND PREDICTABILITY IN THE INTERPRETATION AND APPLICATION OF FEDERAL TAX LAW AND POLICY.

Unlike non-governmental litigants and other federal agencies, the Internal Revenue Service does not deem itself bound by an adverse decision of a federal appellate court but feels free to shop around until it finds a circuit that agrees with its position. There is no principled reason why the federal tax

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[11] The government will likely seek to minimize the precedential effect of the decision below by relying on made-for-litigation regulations, Treas. Reg. §1.162(k)-1 and 1.404(k)-3. T.D. 9282 (Aug. 29, 2006). Apart from the fact that the regulations are inconsistent with the plain meaning of the governing statutes – and thus invalid, *National Cable & Telecommunications Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005), the Commissioner cannot deprive taxpayers of their right to deduct redemptive dividends under §404(k) by bootstrapping its litigating position with self-serving regulations promulgated during the pendency of this case. *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).

collector should be exempted from the application of nonmutual offensive issue preclusion (collateral estoppel) that would be binding on any private participant in the litigation process. *See Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 329-33 (1979); *Restatement (Second) of Judgments* §27 (1980).

Here the government lost the §162(k)(1) issue in the Ninth Circuit. Ralston, General Mills, and Conopco relied on that decision, only to be told "never mind" by other circuits after the expenditure of many hundreds of thousands of dollars in legal fees. That is precisely the type of inconsistent adjudication that collateral estoppel is designed to prevent. *Montana v. United States*, 440 U.S. 147, 153-54 (1979) (federal government collaterally estopped from relitigating issue it earlier lost because such a result "protects their adversaries from the expense and vexation attending multiple lawsuits, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions"); *Alaska Dep't of Environmental Conservation v. E.P.A.*, 540 U.S. 461, 490 n.14 (2004) ("Preclusion principles . . . unquestionably do apply against the United States, its agencies and officers.").

Whether or not absolute concepts of issue preclusion are implicated in this context, the Court at least should signal in unmistakable terms that earlier tax decisions from other circuits should not be lightly disregarded. There is a difference of opinion among – and sometimes within – the various circuits as to the amount of deference to be accorded to a

previous appellate determination on an issue of federal tax law. This confusion only serves to fuel the Commissioner's penchant for circuit-shopping. For instance, the Eighth Circuit itself has said that "This court has long taken the position that uniformity of decision among the circuits is vitally important on issues concerning the administration of the tax laws. . . . Although we are not bound by another circuit's decision, we adhere to the policy that a sister circuit's reasoned decision deserves great weight and precedential value." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985). Such language would provide comfort for conscientious counsel in advising his client that a unanimous reasoned tax decision of a foreign circuit is quite likely to be followed in the client's home circuit.

Likewise, in *Aeroquip-Vickers, Inc. v. Commissioner*, 347 F.3d 173, 181 (6th Cir. 2003), the Sixth Circuit put it this way: "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system. We would therefore hesitate to reject the view of another circuit." (quoting *Nickell v. Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987)). *See also Hill v. Commissioner*, 204 F.3d 1213, 1217-18 (9th Cir. 2000) (same); *Square D Co. v. Commissioner*, 438 F.3d 739, 744 (7th Cir. 2006) (respect for the decisions of other circuits is especially important in tax cases due to the importance of uniformity); *Gibraltar Fin. Corp. v. United States*, 825 F.2d 1568, 1572 (Fed.Cir. 1987) (because of need to ensure equal application of the

tax system to taxpayers, court is not inclined to reach result in conflict with another circuit unless statute or precedent gives it no alternative).

Despite these oft-repeated admonitions, the Eighth Circuit summarily refused to follow *Boise Cascade* in *GMI*, saying that there were "cogent reasons" for departing from the Ninth Circuit's decision (A-56). But those "reasons" amounted to nothing more than a difference of opinion about whether the redemptive dividends and the cashout distributions should be considered two transactions or one – hardly a self-evident or earth-shaking determination, and not one required by any statutory language. That ruling in *GMI* was then invoked to prevent Ralston from even arguing why *Boise Cascade* should be followed.

This Court should reinforce the proper degree of deference to be accorded to tax rulings by sister circuits. In most cases, absent a change in the statutory law, an intervening Supreme Court decision, or a patently irrational or aberrant previous opinion, a subsequent circuit should not depart from existing precedent from another Court of Appeals based on nothing more than a philosophical difference or a terminological quibble. Furthermore, even if "cogent reasons" is a proper test, it was not met here by anything but lip service. *Boise Cascade* was right, but even if, *arguendo*, reasonable minds might differ, sound principles of judicial husbandry dictate that the settled expectations of the taxpaying public should not be unceremoniously subverted on such thin reasoning.

III. THE COURT OF APPEALS VIOLATED THE PLAIN MEANING RULE BECAUSE RALSTON'S CLAIMED DEDUCTIONS ARE NOT BARRED BY §162(k)(1) DUE TO THE EXCEPTION PROVIDED BY §162(k)(2)(A)(iii).

Even if *Boise Cascade* is not followed, Ralston is still entitled to prevail because of the exception to the bar of §162(k)(1) contained in §162(k)(2)(A)(iii) – an issue that was not presented in either *Conopco* or *GMI*. Section 162(k)(2) provides exceptions to the application of §162(k)(1). In particular, §162(k)(2)(A)(iii) specifies that the bar of §162(k)(1) does not apply to "Any . . . deduction for dividends paid (within the meaning of section 561)."[12] Hence, the bar of §162(k)(1) would not apply to Ralston's claimed deductions if they constituted any type of deduction for dividends paid as defined in §561. That is precisely what the claimed deductions are for.

Consistent with its title, "Definition of deduction for dividends paid," §561 is a definitional section setting forth the meaning of the phrase "deduction for dividends paid." Section 561(a) defines a deduction for dividends paid to mean:

> "The deduction for dividends paid shall be the sum of –

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[12] During the tax years in question, this provision was contained in §162(k)(2)(A)(ii), as indicated in the Appendix (A-44). When a new subparagraph (ii) was enacted in 1996, this provision was renumbered as (iii) and has been so cited throughout this case.

> "(1) the dividends paid during the taxable year,
>
> "(2) the consent dividends for the taxable year (determined under section 565), and
>
> "(3) in the case of a personal holding company, the dividend carryover described in section 564."

Section 561(b) states that "in determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) . . . shall be applicable." Section 562(a) provides:

> "For purposes of this part, the term 'dividend' shall, except as otherwise provided in this section, include *only dividends described in section 316* (relating to definition of dividends for purposes of corporate distributions)." (Emphasis added.)

Consequently, there is a "deduction for dividends paid (within the meaning of section 561)," as amplified by §562, when three elements are present: [1] a deduction [2] for dividends paid, [3] which dividends are described in §316.

Regarding the first element – an allowable deduction – §561 does not create or authorize a deduction. In order to be entitled to claim a deduction for a dividend paid, a taxpayer must point to another section of the Internal Revenue Code which grants such a deduction. Here, §404(k)(1) fills that role by

unambiguously authorizing "a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with respect to applicable employer securities."[13] Even the title of §404(k) confirms that it provides a "*Deduction for dividends paid* on certain employer securities."

There also can be no dispute that the second and third elements specified in §§561 and 562 (*i.e.*, [2] dividends paid, [3] which are described in §316) are present here inasmuch as the government does not challenge that "the [redemptive dividends] . . . are treated as dividends for purposes of Code Sections 301 and 316" (Stip. ¶93).

The cardinal rule of statutory construction has been repeatedly articulated by this Court: "'In determining the scope of a statute, we look first to its language. If the statutory language is unambiguous, in the absence of "a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive."'" *Reves v. Ernst & Young*, 507 U.S. 170, 177 (1993), quoting *United States v. Turkette*, 452 U.S. 576, 580 (1981), in turn quoting *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980).

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[13] The government acknowledged that the cashout distributions to terminated participants were paid in cash and that the stock held by the ESOP was "applicable employer securities" (Stip. ¶¶44, 78-86).

Under the plain language of the relevant statutes, the claimed deductions thus fall squarely within the exception provided in §162(k)(2)(A)(iii), even if §162(k)(1) were otherwise applicable, because they are for a "deduction for dividends paid (within the meaning of §561)." Accordingly, Ralston is entitled to the claimed deductions.

The Eighth Circuit's contrary conclusion largely defies analysis. The court (a) noted that a Treasury Regulation interpreting §561 makes reference to five Code sections for which the deduction for dividends paid is applicable, (b) observed that each of those sections references §561, and (c) concluded that because §404(k) does not specifically mention §561, its dividend is not a dividend paid within the meaning of §561 and thus does not satisfy the exception in §162(k)(2)(A)(iii) (A-6). That syllogism prompts some serious head-scratching.

The Court of Appeals attempted to buttress its "a-dividend-is-not-a-dividend" holding by resort to legislative history in which the conferees referred to certain types of corporations and transactions to which §162(k)(2)(A)(iii) would apply (A-7). The report does not purport to treat the cited examples as exclusive and does not indicate that future Congressional grants of deductions would be nullified if the enacting statute did not make express reference to §561. Congress knows how to use the word "only," but did not do so in the passage cited by the court.

In any event, the court's invocation of marginal legislative history transgresses the rule expressed by this Court in *Cooper Industries, Inc. v. Aviall Services, Inc.*, 543 U.S. 157, 167 (2004), "[I]t is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed." (quoting *Oncale v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998)).[14]

To be sure, Congress, in enacting §162(k)(1), intended *generally* to bar a corporation from being able to claim a deduction for amounts paid in connection with the repurchase of its stock. As indicated earlier, the impetus for this enactment was the controversial practice of fending off corporate raiders by paying them "greenmail" to buy back their stock and get rid of them. *See* H.R. Rep. No. 99-426, 99th Cong., 1st Sess. at 248 (1985). But in enacting exceptions to the bar in §162(k)(2), it is equally plain that Congress did not intend §162(k)(1) to prevent a corporation from deducting payments that are truly dividends rather than a mere greenmail-like return of capital. In particular, by enacting §162(k)(2)(A)(iii), Congress did not want §162(k)(1) to prevent a taxpayer from being able to claim a "deduction for dividends paid." The

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[14] Moreover, there is even more compelling legislative history confirming that the Eighth Circuit's interpretation would frustrate the essential Congressional purpose of encouraging ESOPs. *See, e.g.*, 78 Cong. Rec. 2663 (1934); Tax Reform Act of 1976, §803(h), 98 Stat. 1520, 1590 (1976); 129 Cong. Rec. 33813-28 (1983); 130 Cong. Rec. 12697 (1984).

Eighth Circuit's contrary conclusion will be seized upon by the government to challenge the deductibility of other dividends expressly made deductible by a code section that does not expressly refer to §561 – such as §808 (dividends to policyholders) and §591 (dividends by commercial banks and other savings institutions).

The decision below violates this Court's jurisprudence requiring that the statute be given its plain meaning and deprives Ralston of the deduction that Congress conferred upon it.[15]

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[15] An applicable §404(k) dividend arising from the proceeds of a redemptive dividend is not a second-class dividend – just like a rose, a dividend is a dividend by any other name. Yet, under the holdings below, while a cash distribution funded by a regular quarterly or semi-annual dividend would not be barred by §162(k)(1), a cash distribution funded by a redemptive dividend would be barred. Such result makes no economic sense, does not further any Congressional purpose, and certainly could not have been intended by Congress.

CONCLUSION

For the reasons stated, the petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

United States Court of Appeals, Eighth Circuit.

No. 09-1381

Nestlé Purina Petcare Co., Petitioner-Appellant,	* * *	Appeal from the United States Tax Court.
v.	*	
Commissioner of Internal Revenue,	* * *	
Respondent-Appellee.	*	

Submitted: December 15, 2009
Filed: February 9, 2010

Before LOKEN, Chief Judge, ARNOLD and BENTON, Circuit Judges.

BENTON, Circuit Judge.

The tax court ruled, on summary judgment, that Nestlé Purina Petcare Company – hereafter Ralston, its name during the relevant years – could not deduct payments for cash distribution redemptive dividends. ***Ralston Purina Co. v. Comm'r***, 131 T.C. 29 (2008).

Ralston appeals. Having jurisdiction under 26 U.S.C. § 7482, this court affirms.

I.

In 1989, Ralston established an employee stock ownership plan ("ESOP"). *See* 26 U.S.C. §§ 401(a), 401(k), 4975(e)(7). A trust held the ESOP's assets, primarily Ralston preferred stock. Ralston contributed to the ESOP for the benefit of participating employees. In 1994 and 1995, Ralston claimed deductions, totaling over $66 million, for its stated dividends on the preferred stock, which are not at issue.

When a participant left Ralston, the participant was required to direct the ESOP to convert the value of preferred stock allocated to his or her ESOP account into cash, shares of Ralston common stock, or a combination of both. If a participant elected cash, the trust could require that Ralston purchase stock from it, paying the trust a dividend (a "redemptive dividend"). From the redemptive dividend, the Trust could distribute to the participant a "cash distribution redemptive dividend" as part of the total cash distributed to a participant.

Tax Year	Redemptive Dividends	Cash Distribution Redemptive Dividends	Total Cash Distributions To Participants
1994	$3,128,066	$2,317,656	$ 3,907,352
1995	$6,277,965	$7,088,374	$ 8,205,589
Total	$9,406,031	$9,406,030	$12,112,941

Ralston seeks to deduct $9,406,030, the value of the cash distribution redemptive dividends. Ralston argues that 26 U.S.C. § 404(k)(1) allows a deduction for the cash distribution redemptive dividends, or alternatively that a deduction is permitted by § 162(k)(2)(A)(iii). The tax court ruled for the Commissioner.

II.

"Summary judgment is appropriate when there are no genuine issues of material fact, and the moving party is entitled to a judgment as a matter of law." ***Bearden v. Int'l Paper Co.***, 529 F.3d 828, 831 (8th Cir. 2008), *citing* **Fed. R. Civ. P. 56(c)**. This court reviews the tax court's grant of summary judgment de novo and views the evidence in the light most favorable to the nonmoving party. *See* ***Cox v. Comm'r***, 121 F.3d 390, 391 (8th Cir. 1997). This court also reviews de novo the tax court's interpretation of tax statutes. *See* ***Scherbart v. Comm'r,*** 453 F.3d 987, 989 (8th Cir. 2006).

A.

The first issue is whether 26 U.S.C. § 162(k)(1) – enacted two years later – bars the deduction allowed by § 404(k)(1). In ***General Mills, Inc. v. United States***, 554 F.3d 727, 730 (8th Cir. 2009) ("*GMI*"), this Court held that § 162(k)(1) bars a deduction under § 404(k) for amounts paid to a corporation's ESOP trust in order to redeem shares of the corporation's

stock. *See also* ***Conopco, Inc. v. United States***, 572 F.3d 162, 166-67 (3d Cir. 2009) (following the *GMI* opinion, and disagreeing with ***Boise Cascade v. United States***, 329 F.3d 751 (9th Cir. 2003)). "In sum, while § 404(k)(1) allows a deduction, § 162(k)(1) bars it." ***GMI***, 554 F.3d at 730. Since the facts of *GMI* do not materially differ from the facts here, *GMI* controls. *See, e.g.*, ***Passmore v. Astrue***, 533 F.3d 658, 660 (8th Cir. 2008) ("'This panel is bound by Eighth Circuit precedent' and cannot overrule an earlier decision by another panel.") (citations omitted).

B.

In *GMI*, the parties agreed that no exception in § 162(k)(2) applied. *See* ***GMI***, 554 F.3d at 728. One exception, § 162(k)(2)(A)(iii), provides that § 162(k)(1) shall not apply to: "Any deduction for dividends paid (within the meaning of section 561)." Ralston invokes this exception to justify deducting its cash distribution redemptive dividends. Consistent with the cursory briefing, the tax court did not discuss this exception, except to say: "The redemption dividends do not fall within the exceptions provided in section 162(k)." ***Ralston***, 131 T.C. at 35.

Ralston argues that it is claiming a "deduction for dividends paid" within the meaning of § 561. Section 561 refers to §§ 562 and 563 for the rules to determine the deduction-for-dividends-paid. Ralston focuses on the general rule in § 562(a) that the deduction-for-dividends-paid includes "only dividends

described in section 316." Because the parties stipulated that Ralston paid § 316 dividends to the trust, Ralston concludes it paid dividends within the meaning of § 561, and therefore satisfies the § 162(k)(2)(A)(iii) exception.

The parties agree that § 561 does not in itself authorize a deduction, but rather defines a deduction that another section of the Code may authorize. The parties also agree that § 561 defines the deduction-for-dividends-paid for regulated investment companies and real estate investment trusts, and for the purposes of computing the accumulated earnings tax and personal holding company tax. *See* **Treas. Reg.** § 1.561-1(a) (1962) ("The deduction for dividends paid is applicable in determining accumulated taxable income under section 535, undistributed personal holding company income under section 545, undistributed foreign personal holding company income under section 556, investment company taxable income under section 852, and real estate investment trust taxable income under section 857.").

The government interprets the Treasury Regulation as listing the only applications of § 561. Ralston responds that the Treasury Regulation predates §§ 404(k) and 162(k), and still refers to a repealed section of the Code (§ 556). Ralston concludes that the Regulation's list is not exhaustive, and that § 404(k)'s "Deduction for dividends paid on certain employer securities" authorizes a § 561 deduction-for-dividends-paid.

The language of the Code refutes Ralston's conclusion. "The long established plain language rule of statutory construction requires examining the text of the statute as a whole by considering its context, object, and policy." ***Knudsen v. IRS***, 581 F.3d 696, 710 (8th Cir. 2009). Section 162(k)(2)(A)(iii) permits a deduction-for-dividends-paid "within the meaning of section 561." It does not say "within the meaning of section 404(k)." Each Code section listed in the Treasury Regulation expressly incorporates the dividends paid deduction "as defined in section 561." *See* 26 U.S.C. §§ 535(a), 545(a), 852(a), 857(a). The Code only references § 561 in § 162(k)(2)(A)(iii) and in sections implementing the sections that expressly incorporate § 561. *See* 26 U.S.C. §§ 547, 564, 565, 860, 4981, 4982.[1] Section 404(k), which Ralston contends authorizes its deduction, does not reference § 561. "[D]eductions are strictly construed and allowed only 'as there is a clear provision therefor.'" ***INDOPCO, Inc. v. Comm'r***, 503 U.S. 79, 84 (1992), *quoting* ***New Colonial Ice Co. v. Helvering***, 292 U.S. 435, 440 (1934); ***Deputy v. du Pont***, 308 U.S. 488, 493 (1940). Because § 404(k) does not provide for a deduction-for-dividends-paid under § 561, Ralston does not have a "deduction for dividends paid (within the meaning of

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[1] *See also* 26 U.S.C. § 583 (1954 Code, repealed 1976) (Under the 1954 Code, § 583 allowed banks a deduction for dividends paid on certain preferred stock, expressly referencing § 561.

section 561)" needed to satisfy the exception in § 162(k)(A)(iii).

"[T]he true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part." ***Comm'r v. Engle***, 464 U.S. 206, 223 (1984), *quoting* ***Helvering v. Morgan's Inc.***, 293 U.S. 121, 126 (1934). The conference report on the deduction-for-dividends-paid exception in § 162(k)(2)(A)(iii) indicates the scope of the exception:

> ***House Bill***
>
> The House bill provides that no portion of payments by a corporation in connection with a redemption of its stock is deductible. . . .
>
> ***Senate Amendment***
>
> The Senate amendment is generally the same as the House bill, except the provision does not apply to (1) interest deductible under section 163, (2) amounts constituting dividends for purposes of the accumulated earnings, personal holding company, and foreign personal holding company taxes, and for purposes of the regular income tax in the case of regulated investment companies and real estate investment trusts, or (3) otherwise deductible expenses incurred by a regulated investment company that is an open-end mutual fund in connection with the

> redemption of its stock upon demand of a shareholder. . . .
>
> ***Conference Agreement***
>
> The conference agreement generally follows the Senate amendment, with certain modifications and clarifications. . . .

H.R. Rep. No. 99-841, at II-168 (Conf. Rep. 1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4256. Ralston emphasizes the years-earlier floor statements about § 404(k), reflecting Congress's intent to encourage ESOPs. The later conference report on § 162(k) trumps the legislative history Ralston cites. *See* ***Sierra Club v. Clark***, 755 F.2d 608, 615 (8th Cir. 1985), *quoting* ***Demby v. Schweiker***, 671 F.2d 507, 510 (D.C. Cir. 1981) ("Because a 'conference report represents the final statement of terms agreed to by both houses, next to the statute itself it is the most persuasive evidence of congressional intent.'"). The conference report confirms the language of the Code. The exception in § 162(k)(2)(A)(iii) applies only where the Code has authorized the taxpayer to take a deduction-for-dividends-paid within the meaning of § 561. Section 404(k) does not authorize such a deduction. Therefore, Ralston may not deduct its cash distribution redemptive dividends.

III.

The judgment of the tax court is affirmed.

APPENDIX B

131 T.C. No. 4

UNITED STATES TAX COURT

RALSTON PURINA COMPANY AND SUBSIDIARIES, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7357-00. Filed September 10, 2008.

P, a Missouri corporation, claimed a deduction under I.R.C. sec. 404(k) for payments made to its employee stock ownership plan in redemption of P's preferred stock owned by the plan, where the proceeds of that payment were distributed to employees terminating their participation in the plan. R argues that payments to redeem stock are not deductible under either I.R.C. sec. 404(k)(1) or (5), or in the alternative that deduction of these payments is barred by the provisions of I.R.C. sec. 162(k).

Held: I.R.C. sec. 162(k) renders the payments nondeductible because the payments are in connection with a redemption of stock. The result to the contrary reached by the U.S. Court of Appeals for the Ninth Circuit on almost identical facts in *Boise Cascade Corp. v. United States,* 329 F.3d 751 (9th Cir. 2003), respectfully will not be followed.

Kenneth A. Kleban, for petitioner.

Lawrence C. Letkewicz and *Dana E. Hundrieser*, for respondent.

OPINION

NIMS, *Judge*: Before the Court are petitioner's and respondent's cross-motions for summary judgment pursuant to Rule 121.

Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the years in issue.

Rule 121(a) provides that either party may move for summary judgment upon all or any part of the legal issues in controversy. Full or partial summary judgment may be granted only if it is demonstrated that no genuine issue exists as to any material fact and that the legal issues presented by the motion may be decided as a matter of law. See Rule 121(b); *Sundstrand Corp. v. Commissioner,* 98 T.C. 518, 520 (1992), aff'd. 17 F.3d 965 (7th Cir. 1994). As to the issues presented on these cross-motions for summary judgment, we conclude that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law.

The sole issue remaining for decision is whether petitioner may claim deductions for amounts paid in redemption of preferred stock held by its employee stock ownership plan (ESOP) for its 1994 and 1995 tax years. This issue was raised for the first time by petitioner in its second amendment to petition (second amendment). All other issues, of which there were many, have been settled. Respondent consented to the filing of the second amendment.

Background

The parties filed an extensive stipulation of facts with accompanying exhibits which forms the factual setting for their respective arguments and which provides the basis for our Background discussion.

Petitioner is a Missouri corporation and had its principal place of business in St. Louis, Missouri, when its petition was filed. In 1989 petitioner amended its Savings Investment Plan (SIP or plan) for employees, adding an employee stock ownership plan (ESOP). Boatmen's Trust Co. (Boatmen's) was trustee of the ESOP portion of the SIP. Vanguard Fiduciary Trust Co. was named recordkeeper for the SIP and was responsible for making distributions to plan participants. The trust fund under the SIP was exempt from income tax under section 501(a). For convenience, references hereinafter to the SIP include, where appropriate, the trust fund under the SIP.

The managers of the SIP created a Benefits Policy Board (BPB) comprising employees appointed by petitioner's chief executive officer. They also created an Employee Benefit Asset Investment Committee (EBAIC), the members of which were appointed by petitioner's board of directors. Petitioner's board of directors, the BPB, the EBAIC, and the trustees were among the fiduciaries responsible for the administration of the SIP.

Boatmen's trust agreement provided that Boatmen's would make distributions from the SIP in cash

or in kind to such person, in such amounts, at such times, and in such manner as directed by the EBAIC. The EBAIC could, at its sole discretion, direct Boatmen's to pay any cash dividends on shares of preferred stock (see below for definition) directly to plan participants. The EBAIC could also decide how any payments to plan participants would be funded. Petitioner could not use amounts in the SIP for any purpose other than the benefit of the SIP participants.

In connection with the creation of the ESOP, petitioner's board authorized the issuance of 4,600,000 shares of newly created convertible preferred stock (preferred stock). These shares could be issued only in the name of an ESOP trustee and were not readily tradable on an established market. Shares of the preferred stock were entitled to receive, when, as, and if declared by petitioner's board, cumulative cash dividends (stated dividends) in an amount per share equal to $7.48 per annum, payable semiannually, one-half on June 29 and one-half on December 30 of each year commencing June 29, 1989.

On February 1, 1989, the SIP purchased 4,511,414 shares of preferred stock from petitioner at $110.83 per share. To finance this purchase, the SIP borrowed $500 million from institutional lenders. Petitioner guaranteed the ESOP loans. The loans matured in approximately 10 years with principal and interest payable semiannually.

The SIP purchased an additional 88,586 shares of preferred stock during the years 1990-92, also at $110.83 per share. The SIP funded these purchases through employee contributions.

Plan participants could make contributions to the ESOP up to 6 percent of their before-tax income. Any contributions in excess of 6 percent were invested outside the SIP in investment funds of the participant's choosing. Participants were not permitted to invest any after-tax income in the ESOP. Participants' basic matched contributions were fully vested at all times. Company matching contributions became vested over a period of 4 years. These matching contributions also included payments by petitioner to the ESOP preferred stock fund in amounts necessary to make ESOP loan amortization payments.

Employee participation in the SIP ended upon termination of employment for any reason. Terminated participants had the option, among others, to cash out their investment in the ESOP. The SIP could, in its sole discretion, require petitioner to redeem shares of preferred stock at any time upon notice, when and to the extent necessary to provide required distributions to terminated participants electing to cash out their investments, or to make payments on the ESOP loan. The payment by the SIP to terminated participants could be made, at the SIP's option, in cash or shares of petitioner's common stock. The SIP also had the option to satisfy distributions to terminated participants without forcing petitioner to redeem stock.

At all relevant times the plan year of the SIP was the calendar year. For plan years 1989 through 1993 the SIP made distributions to terminated participants using cash otherwise available to it.

The first relevant redemption by petitioner of preferred stock held by the SIP occurred in August 1994. Petitioner redeemed 28,224 shares of preferred stock for $3,128,066. The SIP distributed that entire amount to terminated participants by December 31, 1994. During this period the SIP also made $1,589,696 in distributions to terminated participants out of cash otherwise available.

In February 1995 petitioner redeemed another 56,645 shares of preferred stock from the SIP for $6,277,965. All of the proceeds were distributed to terminating participants from February 21 through July 20, 1995. During this period the SIP made additional distributions of $1,927,624 from cash otherwise available.

Petitioner timely filed consolidated Forms 1120, United States Corporation Income Tax Return, for its taxable years ending September 30, 1994 and 1995. Respondent issued a statutory notice of deficiency to petitioner dated April 6, 2000, pertaining to petitioner's 1993, 1994, and 1995 tax years. Petitioner filed a petition contesting many of the adjustments respondent made in the notice of deficiency, none of which concerned petitioner's ESOP. Petitioner filed an amendment to petition on February 24, 2003, and the second amendment on December 9, 2003. In the

second amendment petitioner asserted for the first time that it was entitled to an additional deduction, under section 404(k), for amounts it paid to the SIP to redeem its preferred stock that were then distributed to plan participants.

Discussion

Petitioner claims as deductions its payments in redemption of preferred stock held by the SIP the proceeds of which the SIP subsequently distributed to terminating employees. Petitioner contends these payments are essentially equivalent to dividends within the meaning of section 302(b)(1) (redemption dividends). Respondent does not challenge this contention – rather that the redemption dividends are deductible. The SIP used the redemption dividends to make distributions to the employee participants in the SIP who had terminated their participation because of retirement or for some other reason.

Petitioner asserts that the redemption dividends qualify as applicable dividends under section 404(k)(2). For the taxable years at issue, section 404(k) provided in relevant part:

> SEC. 404(k). Deduction for Dividends Paid on Certain Employer Securities. –
>
> > (1) General rule. – In the case of a corporation, there shall be allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with

respect to applicable employer securities. Such deduction shall be in addition to the deductions allowed under subsection (a).

(2) Applicable dividend. – For purposes of this subsection –

(A) In general. – The term "applicable dividend" means any dividend which, in accordance with the plan provisions –

(i) is paid in cash to the participants in the plan or their beneficiaries,

(ii) is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid, or

(iii) is used to make payments on a loan described in subsection (a)(9) the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

* * *

(3) Applicable employer securities. – For purposes of this subsection, the term "applicable employer securities" means, with respect to any dividend, employer securities which are held on the record date for such

dividend by an employee stock ownership plan which is maintained by –

(A) the corporation paying such dividend, or

* * *

(4) Time for deduction. –

(A) In general. – The deduction under paragraph (1) shall be allowable in the taxable year of the corporation in which the dividend is paid or distributed to a participant or his beneficiary.

(B) Repayment of loans. – In the case of an applicable dividend described in clause (iii) of paragraph (2)(A), the deduction under paragraph (1) shall be allowable in the taxable year of the corporation in which such dividend is used to repay the loan described in such clause.

(5) Other rules. – For purposes of this subsection –

(A) Disallowance of deduction. – The Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation.

* * *

(6) Definitions. – For purposes of this subsection –

> (A) Employer securities. – The term "employer securities" has the meaning given such term by section 409(l).
>
> (B) Employee stock ownership plan. – The term "employee stock ownership plan" has the meaning given such term by section 4975(e)(7). Such term includes a tax credit employee stock ownership plan (as defined in section 409).

Respondent does not challenge the treatment of the preferred stock as "employer securities" as defined in section 409(l).

Petitioner raised this section 404(k) issue for the first time in the second amendment, which, as stated above, petitioner filed without objection by respondent, after the decision of the U.S. Court of Appeals for the Ninth Circuit in *Boise Cascade Corp. v. United States,* 329 F.3d 751 (9th Cir. 2003), on May 20, 2003. In that case the Court of Appeals decided an ESOP preferred stock redemption issue almost identical to the issue for decision in this case. The *Boise Cascade Corp.* result is not controlling in this case, in which any appeal would normally lie to the Court of Appeals for the Eighth Circuit. See *Golsen v. Commissioner,* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

Respondent maintains that the issue was incorrectly decided by the Court of Appeals for the Ninth Circuit and challenges the claimed deductions on three grounds: (1) The redemption dividends are not applicable dividends within the meaning of section

404(k); but (2) even if the redemption dividends otherwise constitute applicable dividends as defined by section 404(k), their deduction should be disallowed as evasions of taxation under section 404(k)(5); and (3) even if the redemption dividends are otherwise allowable as deductions under section 404(k), they are disallowed as amounts paid by a corporation in connection with the redemption of its stock within the meaning of section 162(k).

In reaching our decision we need not traverse petitioner's convoluted arguments in support of its position that the redemption dividends qualify as applicable dividends under section 404(k)(2), or respondent's arguments regarding section 404(k)(5), because in our view section 162(k) precludes that result in any event, notwithstanding the contrary position taken by the Court of Appeals.

Section 162(k) provides:[1]

SEC. 162(k). Stock Redemption Expenses. –

---

[1] The Small Business Job Protection Act of 1996, Pub. L. 104-188, sec. 1704(p), 110 Stat. 1886, amended sec. 162(k)(1) by striking "the redemption of its stock" and inserting "the reacquisition of its stock" effective for amounts paid or incurred after Sept. 13, 1995, in tax years ending after that date. The net effect of the amendment was simply to broaden the scope of sec. 162(k)(1) beyond the technical boundaries of "redemption". This amendment does not apply to petitioner's redemptions, for while petitioner's 1995 fiscal year ended on Sept. 30, 1995, all of the redemption and distribution transactions occurred before Sept. 13, 1995.

(1) In general. – Except as provided in paragraph (2), no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of its stock.

(2) Exceptions. – Paragraph (1) shall not apply to –

(A) Certain specific deductions. – Any –

(i) deduction allowable under section 163 (relating to interest), or

(ii) deduction for dividends paid (within the meaning of section 561).

(B) Stock of certain regulated investment companies. – Any amount paid or incurred in connection with the redemption of any stock in a regulated investment company which issues only stock which is redeemable upon the demand of the shareholder.

The redemption dividends do not fall within the exceptions provided in section 162(k).

Petitioner seeks to have us adopt the position taken by the Court of Appeals that, as discussed below, the distribution payments from the ESOP were not "in connection with" the redemption payments made by petitioner and as a result the entire transaction did not run afoul of section 162(k).

The Court of Appeals' rationale runs along the following lines. The parties stipulated that for purposes of section 302(b), if the ESOP is treated as the owner of the redeemed preferred stock, then the redemptions did not result in a meaningful reduction in the ESOP's proportionate interest in petitioner and thus would qualify for dividend treatment under section 316. The Court of Appeals concluded that the ESOP was the owner of the stock; this established the status of the stock redemption payments as dividends. The court then had to determine whether this dividend ran afoul of section 162(k).

Section 162(k) itself is an exception to the general rule of section 162(a) that permits a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". It prohibits deductions for expenses that would ordinarily be deductible business expenses but for the fact that those expenses were made in connection with a repurchase of stock. In the words of the court in *Boise Cascade Corp. v. United States, supra* at 756: "Section 162(k) prohibits deductions claimed as a consequence of a stock redemption. Thus, it acts as a disallowance provision for otherwise allowable non-capital deductions incurred in connection with a stock redemption transaction." *Boise Cascade Corp.* goes on to say that "the key question is whether distributions to the [ESOP] Participants were payments made 'in connection with' the redemption of the convertible preferred stock." *Id.* at 757.

In a nutshell, *Boise Cascade Corp.* appears to proceed on the premise that if distribution payments to the withdrawing ESOP participants are made "in connection with" redemption of stock, then section 162(k) disallows a deduction for the amounts paid. The Court of Appeals then held that the payments were not made in connection with the redemption of its stock. *Id.* at 757-758.

The Court of Appeals' holding relied heavily on its previous decision in *United States v. Kroy (Europe) Ltd.*, 27 F.3d 367 (9th Cir. 1994), regarding the meaning of the phrase "in connection with" in section 162(k). In *Kroy,* the Court of Appeals interpreted the phrase narrowly to hold that expenses incurred to borrow funds used to effect a redemption were not in connection with a redemption. The court reasoned that Congress, in enacting section 162(k), did not intend to overrule the "origin of the claim" test for determining whether expenses were deductible under section 162 generally. *Id.* at 369-370. Therefore, the court interpreted the phrase "in connection with" to include only expenses that have their origin in a stock redemption transaction, excluding expenses that have their origin in a "separate, although related, transaction". *Id.* at 369.

We specifically rejected the Court of Appeals' narrow interpretation of the phrase "in connection with" in *United States v. Kroy (Europe) Ltd., supra.* See *Fort Howard Corp. & Subs. v. Commissioner,* 103 T.C. 345 (1994). In *Fort Howard,* we noted that Congress had expressly intended the phrase to be construed

broadly, to include all deductions necessary or incident to a redemption transaction. *Id.* at 353-354 (citing S. Rept. 99-313, at 223 (1986), 1986-3 C.B. (Vol. 3) 1, 223). We also relied heavily on the opinion of the Court of Appeals for the Eighth Circuit in *Huntsman v. Commissioner*, 905 F.2d 1182 (8th Cir. 1990), revg. 91 T.C. 917 (1988), which held that the phrase "in connection with" should be broadly construed. We concluded that the origin of the claim test had no bearing on the section 162(k) inquiry, rejecting *Kroy*'s assumption that the "in connection with" test under section 162(k) must be fashioned in such a way as to be consistent with the origin of the claim test. We also concluded that Congress could not have intended section 162(k) as a mere clarification of existing law, because section 162(k) prohibits deductions that are "otherwise allowable" under present law. *Fort Howard Corp. & Subs. v. Commissioner*, *supra* at 356. Two years after our Opinion in *Fort Howard*, Congress enacted retroactive relief for the borrowing expenses involved in both *Fort Howard* and *Kroy*. See *Fort Howard Corp. & Subs. v. Commissioner*, 107 T.C. 187 (1996). Ultimately, our holding in this case does not depend on our interpretation of the phrase "in connection with" because we conclude that Congress expressly intended section 162(k) to prohibit deduction of the funds used to effect a redemption. See *infra* pp. 21-22.

Petitioner urges us to adopt the Court of Appeals for the Ninth Circuit's reasoning, arguing that while the transaction as a whole qualifies for a deduction

under section 404(k), the distribution payments from the SIP to terminating employees are not connected with petitioner's redemption of its preferred stock and thus do not run afoul of section 162(k).

We note at the outset that this line of argument appears to be facially inconsistent. Petitioner first argues that the redemption payments from petitioner to the SIP and the distribution payments from the SIP to the employees are linked in an integrated transaction, so that the transaction fits within one of the transactions permissible under section 404(k) – a dividend payment from a corporation to a plan and a distribution of those proceeds to departing employees. Petitioner then argues that these payments are in fact not connected for purposes of section 162(k). Petitioner seems to want it both ways; it relies on the integrated form of the transaction to justify a section 404(k) deduction only to deny that form in another context. See *Portland Golf Club v. Commissioner*, 497 U.S. 154, 168 (1990) (noting an "inherent contradiction" where taxpayer relied on two methods of calculation to simultaneously show actual losses and an intent to profit).

While this contradiction tends to undercut petitioner's argument, there is a more serious flaw in petitioner's argument: both petitioner and the Court of Appeals for the Ninth Circuit have framed the section 162(k) issue incorrectly. The Court of Appeals in *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003), held, and petitioner asserts, that the proper question for section 162(k) purposes is

whether the distribution payment is "in connection with" a redemption. The court offers no rationale for framing the issue as it does. We infer, as petitioner does, that the court believed that the distribution payment from the SIP to the departing employees was the payment for which the taxpayer sought a deduction. This belief is incorrect, as it misunderstands the nature of the deduction sought under section 404(k).

Section 162(k) bars the deduction of "otherwise allowable" deductions that are made in connection with a repurchase of stock. The deduction sought is the section 404(k) deduction. Section 404(k)(1) provides that a corporation is entitled to a deduction for "any applicable dividend" that it pays with respect to applicable employer securities. (We shall assume, arguendo, that deductions for the payments petitioner made here would normally be allowable under section 404(k).) A deduction under section 404(k) is not allowable unless the transaction qualifies as an applicable dividend. Thus, the proper question for section 162(k) purposes is whether the otherwise deductible applicable dividends that petitioner paid are "in connection with" a repurchase of stock. To answer this question, we must identify the transaction that constitutes the applicable dividend.

As for what payment in this case could constitute an applicable dividend under section 404(k), there are three possibilities: (1) The redemption payment from petitioner to the SIP, (2) the distribution payments from the SIP to departing employees, or (3) the

redemption payment to the SIP and the distribution from the SIP as an integrated transaction. The court in *Boise Cascade Corp. v. United States, supra,* without analysis of section 404(k), determined that the second option was correct – that the distribution payment from the plan to the departing employees was the deductible applicable dividend to be analyzed under section 162(k). *Id.* at 754 ("if the distributions to the employees were a distribution under § 301, then they were a 'dividend' for the purposes of § 316 and the deduction provided for in § 404(k) applies"). For the reasons discussed below, that position is unsupportable under section 404(k). Rather, it is both the redemption payment and the distribution of that payment, as an integrated transaction, that constitutes the applicable dividend under section 404(k).

Under section 404(k)(1), a corporation is entitled to a deduction for applicable dividends that the corporation pays – either to an ESOP or to plan participants directly. Payments made to an ESOP must then be distributed by the ESOP, either to plan participants or to pay off ESOP debt. Sec. 404(k)(2). An applicable dividend, as applied here, is "any dividend which * * * is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year". Sec. 404(k)(2)(A). Thus, the applicable dividend as defined requires both a payment from a corporation and a distribution of that payment to departing employees.

Petitioner made payments in redemption of the preferred stock held by the SIP. The redemption payments were made by petitioner (the corporation) to the SIP (the plan). The SIP properly distributed those payments. The redemption payments fit the technical definition of a dividend for purposes of sections 301 and 316, because the redemptions did not result in a meaningful reduction in the ESOP's proportionate interest in petitioner. See sec. 302(b). However, they would not have been applicable dividends unless the SIP later distributed those payments in the prescribed manner.

Distribution payments from the SIP to terminating employees, standing alone, do not fit the definition of applicable dividends for two reasons. First, an applicable dividend must be paid by the corporation, and the SIP is not the corporation – petitioner is. Second, the distributions from the SIP are not dividends at all, because a dividend is defined as a payment by a corporation to its shareholders. Sec. 316(a). The SIP is the owner of the preferred stock; it cannot be the payor of dividends under section 316. These distribution payments represent only the distribution of the proceeds of a dividend paid by petitioner to the SIP. Thus, a distribution payment alone cannot be an applicable dividend as that term is defined under section 404(k). Rather, both sides of these redemption transactions – redemption and distribution – are necessary for the transactions to fit the definition of applicable dividends found in section 404(k).

Petitioner argues that the SIP distribution alone must be the deductible applicable dividend because that distribution determines the timing and the amount of the deduction, as the SIP can choose the amount of petitioner's payment that it distributes to employees and when it distributes that payment. As stated above, no payment from petitioner to the SIP would be deductible under section 404(k) without subsequent distribution – either to terminating participants or to pay off SIP debt. See sec. 404(k)(2)(A)(ii) and (iii). However, the reverse is true as well: without a payment from petitioner to the SIP, no distribution from the SIP would be deductible, because section 404(k)(1) requires that the "applicable dividend" be paid "by such corporation." For that reason, petitioner cannot claim a deduction for the distributions the SIP made to employees out of cash otherwise available.

Similarly, the court in *Boise Cascade Corp. v. United States*, 329 F.3d at 757-758, was incorrect when it framed the section 162(k) test as being whether the distribution payment from the plan was "in connection with" a redemption, because the distribution, standing alone, is not deductible under section 404(k), and without an allowable deduction a section 162(k) analysis is not necessary. The "connection" that must be made is between the redemption payment and the distribution payment as required by section 404(k). The payment from petitioner to the SIP to the departing employees is a statutorily integrated transaction. The two sides of the transaction are necessarily connected, because the SIP must

distribute the same funds paid to it by petitioner. Once that connection is established, deduction under section 404(k) is possible. That entire transaction, now potentially deductible as an applicable dividend under section 404(k), must also pass muster under section 162(k). The test is whether the "otherwise allowable" deduction for the payment of an applicable dividend is nevertheless disallowed because the payment is "in connection with" a repurchase of stock.

Petitioner's payments of these asserted applicable dividends were certainly in connection with a repurchase of stock. The first part of the applicable dividend transaction was the redemption. The funds of the transaction, passed from petitioner to the SIP to the departing employees, are the same funds used to repurchase stock. Section 162(k) bars a deduction for the payment of funds used to repurchase stock. See S. Rept. 99-313, at 223 (1986), 1986-3 C.B. (Vol. 3) 1, 223 ("The committee intends that amounts subject to this provision will include amounts paid to repurchase stock"). Therefore, the first part of the integrated transaction – the redemption of stock from the SIP – ensures that section 162(k) bars the deduction of any portion of the transaction.

As a result, we hold that section 162(k) prevents petitioner from claiming as deductions the amounts it paid to repurchase its own stock from its ESOP which were then distributed to terminating employees. For the reasons given, we respectfully decline to follow the contrary result reached on almost identical facts by the U.S. Court of Appeals for the Ninth Circuit in

Boise Cascade Corp. v. United States, 329 F.3d 751 (9th Cir. 2003).[2]

Therefore, we shall grant respondent's motion for summary judgment and deny petitioner's motion for summary judgment. In doing so, we have considered all of the parties' arguments, and to the extent not discussed, we find them moot. In accordance with the foregoing,

An appropriate order will be issued, and decision will be entered under Rule 155.

Reviewed by the Court.

COLVIN, COHEN, SWIFT, WELLS, HALPERN, VASQUEZ, GALE, THORNTON, MARVEL, HAINES, WHERRY, and HOLMES, *JJ.*, agree with this majority opinion.

GOEKE and KROUPA, *JJ.*, did not participate in the consideration of this opinion.

SWIFT, *J.*, concurring. Regardless of whether petitioner's redemption dividends should be disallowed under section 162(k)(1), respondent argues in the alternative that the redemption dividends should be

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[2] We note that the decision of the District Court in *Conopco, Inc. v. United States*, 100 AFTR 2d 5296, 2007-2 USTC par. 50,582 (D.N.J. 2007), is to a similar effect, in that it disagrees with the holding in *Boise Cascade*. Contra *General Mills, Inc. v. United States*, 101 AFTR 2d 550, 2008-1 USTC par. 50,141 (D. Minn. 2008).

disallowed pursuant to his determination under section 404(k)(5)(A). Thereunder, Congress provided that "The Secretary may disallow the deduction under * * * [section 404(k)(1)] for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation."

In the light of case authority that redemption dividends should not be disallowed under section 162(k)(1),[1] I believe this Court should address respondent's alternative argument under section 404(k)(5)(A).

It is most unusual in a particular Code section to have an express and specific delegation to the Secretary of authority to disallow on the grounds of tax evasion the very deduction provided in the section. On its face and given its placement in section 404(k), section 404(k)(5)(A) appears to give the Secretary authority to do just that.

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[1] Although one court has upheld the Commissioner's disallowance under sec. 162(k)(1) of deductions for redemption dividends, see *Conopco, Inc. v. United States*, 100 AFTR 2d 5296, 2007-2 USTC par. 50,582 (D.N.J. 2007) (unpublished opinion, see 8th Cir. R. 32.1A), three courts have rejected sec. 162(k)(1) as a basis for disallowing deductions for redemption dividends, see, e.g., *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003), affg. 82 AFTR 2d 7249 (D. Idaho 1998); *General Mills, Inc. v. United States*, 101 AFTR 2d 550, 2008-1 USTC par. 50,141 (D. Minn. 2008). *General Mills* and *Conopco* are pending appeal to the United States Courts of Appeals for the Third and the Eighth Circuits, respectively.

In section 7805(a) Congress has delegated to the Secretary general authority to promulgate interpretative rules and regulations, and in a number of Code sections Congress has delegated to the Secretary additional authority to promulgate regulations under the specific sections. The jurisprudence relating to the deference to be given such regulations is well known. See, e.g., *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008), vacating 126 T.C. 96 (2006).

The delegation Congress made to the Secretary in section 404(k)(5)(A), however, is particularly specific and broad and is not limited to the promulgation of regulations. In section 404(k)(5)(A) Congress appears to have delegated to the Secretary authority to place a "tax evasion" label on a particular transaction or type of transaction by regulation, by ruling, or by other public or private notice. No particular requirement or limitation is set forth in section 404(k)(5)(A) as to how the Secretary is to make the "tax evasion" determination, as to how specific and detailed the Secretary's public explanation thereof need be, or as to how the Secretary is to make the "tax evasion" announcement.

For a number of years now and on a number of occasions, under authority of section 404(k)(5)(A) a "tax evasion" label has been placed by the Commissioner and/or by the Government on redemption dividends and claimed deductions under section 404(k)(1) relating thereto have been disallowed: First, in the

litigation of *Boise Cascade Corp. v. United States,* 329 F.3d 751 (9th Cir. 2003); second, by issuance of Rev. Rul. 2001-6, 2001-1 C.B. 491; third, in the litigation of *Conopco, Inc. v. United States,* 100 AFTR 2d 5296, 2007-2 USTC par. 50,582 (D.N.J. 2007); fourth, in the litigation of *General Mills, Inc. v. United States,* 101 AFTR 2d 550, 2008-1 USTC par. 50,141 (D. Minn. 2008); fifth, in the instant litigation; and sixth, in final regulations promulgated in 2006 under sections 162(k) and 404(k), see secs. 1.162(k)-1(a), 1.404(k)-3, Income Tax Regs.

Under section 404(k)(5)(A) in 2001 the Commissioner issued Rev. Rul. 2001-6, *supra.*[2] Certainly, the Office of Chief Counsel advised the Commissioner and was the primary drafter of Rev. Rul. 2001-6, *supra*. The revenue ruling, however, clearly was issued by the Commissioner as are all revenue rulings to whom the Secretary has delegated such authority as reflected in Treas. Dept. Order 150-10 (April 22, 1982). See sec. 7803(a).

Letter rulings and technical advice memoranda are issued by the Commissioner's Office of Chief Counsel. That office, however, only drafts and proposes revenue rulings and revenue procedures. See IRS Deleg. Order 190 (Rev. 4, Oct. 8, 1996), Internal Revenue Manual (IRM), pt. 1.2.53.5, (Oct. 8, 1996); Gen. Counsel Order 4 (Jan. 19, 2001), IRM pt. 30.2,

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[2] Sec. 7701(a)(11)(B) defines "Secretary" as "the Secretary of the Treasury or his delegate."

Exhibit 30.2.2-6 (Aug. 11, 2004); see also sec. 7803(b)(2)(B).

Rev. Rul. 2001-6, *supra*, was approved and issued by the Assistant to the Commissioner, acting on the Commissioner's behalf, and was published in the Internal Revenue Bulletin, 2001-6 I.R.B. 491, the authoritative publication of the Commissioner for announcement of official rulings pertaining to internal revenue matters. See sec. 601.601(d)(1), Statement of Procedural Rules ("The Internal Revenue Bulletin is the authoritative instrument of the Commissioner for the announcement of official rulings, decisions, opinions, and procedures, and for the publication of Treasury decisions, Executive orders, tax conventions, legislation, court decisions, and other items pertaining to internal revenue matters."); see also *id.* sec. 601. 601(d)(2)(ii)(a), (vii)(a) and (b).

Also in 2001 Congress addressed the section 404(k)(5)(A) and by amendment clarified the Secretary's authority thereunder by adding the word "avoidance". Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, sec. 662(b), 115 Stat. 142.

I would note that the Commissioner's disallowance of deductions under section 404(k)(1), based on the discretion given to him in section 404(k)(5)(A), need not involve an analysis and findings of "badges of fraud" typically associated with prosecutions under section 7201 of affirmative attempts by taxpayers to engage in willful tax evasion and with determinations

of willful civil tax fraud penalties under section 6663. See, e.g., *Spies v. United States*, 317 U.S. 492, 499 (1943).

Indeed, in this case petitioner filed its corporate Federal income tax returns for 1994 and 1995 without claiming deductions for redemption dividends. At this time no underpayments of tax are associated with the claimed section 404(k)(1) deductions. Not until December 9, 2003 (2 years after Rev. Rul. 2001-6, *supra*, was issued), did petitioner file (via its second amendment to petition herein) claims for refund for 1994 and 1995, asking respondent and this Court to consider the deductibility of petitioner's redemption dividends and if allowed to refund overpayments of taxes paid. There are no "badges of fraud" to be found here, and respondent does not contend otherwise. Rather, respondent simply contends that allowance of petitioner's claimed redemption dividend deductions would be improper and would give rise to under payments of Federal income taxes which the Commissioner, exercising his discretion under section 404(k)(5)(A), has described as tax evasion.

The tax "evasion" or "avoidance" label placed by the Commissioner on redemption dividends under the authority of section 404(k)(5)(A) is somewhat analogous to the tax "evasion" or "avoidance" label that the Commissioner occasionally places on transactions under the authority given to him in other Code sections. For example, in section 269 the Commissioner is given substantial discretionary authority to label a transaction as engaged in for the principal purpose of

tax evasion or avoidance and to disallow related deductions. The tax "evasion" or "avoidance" which the Commissioner typically identifies under section 269 refers to the underlying nature and purpose of the transaction, not to what we typically consider "badges of fraud", such as a taxpayer's double set of books, destruction of evidence, or omitted income. The tax evasion or avoidance typically involved under section 269 may be described simply as involving a transaction in which a taxpayer is attempting to secure a tax benefit which it "would not otherwise enjoy" and which the Commissioner, in his discretion, has identified as having a principal tax evasion purpose. See *Southland Corp. v. Campbell,* 358 F.2d 333, 336 (5th Cir. 1966).[3]

Here respondent has labeled redemption dividends as transactions that inherently provide to a corporate ESOP sponsor tax deductions to which it is not entitled. In Rev. Rul. 2001-6, *supra*, it is explained that the allowance of deductions for redemption dividends would give corporate ESOP sponsors deductions for payments that do not represent true economic costs and that redemption dividends vitiate important rights and protections for recipients of ESOP distributions.

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[3] I emphasize that the sec. 404(k)(5)(A) authority to disallow a claimed sec. 404(k)(1) deduction because it would constitute a tax evasion transaction is even more specific than the authority set forth in sec. 269.

In spite of the brevity of the explanation provided in Rev. Rul. 2001-6, *supra,* I believe that in the light of section 404(k)(5)(A) the tax evasion label that has been placed on redemption dividends by the Commissioner is entitled to substantial deference. See *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.,* 467 U.S. 837 (1984). While notice-and-comment rule making generally assures *Chevron* deference for regulations, the absence of such formality in the issuance of rulings does not preclude such deference where Congress intended to grant the agency the power to make rules with the "force of law" and "the agency interpretation claiming deference was promulgated in the exercise of that authority." *United States v. Mead Corp.,* 533 U.S. 218, 226-227 (2001); see *Barnhart v. Walton,* 535 U.S. 212, 221-222 (2002).

Lastly, as stated, in 2006 the Secretary promulgated final regulations reflecting the position set forth in Revenue Ruling 2001-6. See sec. 1.162(k)(1), Income Tax Regs.; sec. 1.404(k)-3, Q&A-1, Income Tax Regs. ("Payments to reacquire stock held by an ESOP * * * used to make benefit distributions to participants" are not allowed under section 404(k)(2) and (5)). Although the regulations apply only prospectively and only to amounts paid or incurred after August 30, 2006, secs. 1.162(k)-1(c), 1.404(k)-3, Q & A-2, Income Tax Regs., the regulations are relevant as they are consistent with Rev. Rul. 2001-6, *supra,* see *Smiley v. Citibank (S.D.), N.A.,* 517 U.S. 735, 744 n.3 (1996) ("Where * * * a court is addressing transactions that occurred at a time when there was no

clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means.").

For the reasons stated, I would address respondent's alternative argument and conclude that respondent's determination -- that the claimed deductions for redemption dividends, if allowed, would constitute impermissible tax evasion – should be sustained.

UNITED STATES TAX COURT
Washington, D.C. 20217

RALSTON PURINA COMPANY AND SUBSIDIARIES, Petitioner,	)	
v.	)	Docket No. 7357-00
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

ORDER

Pursuant to the determination of the Court, as set forth in its Opinion filed September 10, 2008, it is

ORDERED that respondent's Motion for Partial Summary Judgment, filed November 13, 2001, is denied as moot. It is further

ORDERED that petitioner's Motion for Partial Summary Judgment, filed January 23, 2002, is denied as moot. It is further

ORDERED that respondent's Motion for Protective Order, filed March 1, 2002, is denied as moot. It is further

ORDERED that respondent's Motion for Summary Judgment, filed December 11, 2006, is granted. It is further

ORDERED that petitioner's Motion for Summary Judgment, filed December 13, 2006, is denied.

(signed) ARTHUR L. NIMS, III
Arthur L. Nims, III
Judge

Dated: Washington, DC
September 10, 2008

UNITED STATES TAX COURT

RALSTON PURINA COMPANY and SUBSIDIARIES,	)	
Petitioners,	)	Docket No. 7357-00
v.	)	Judge Arthur L. Nims, III
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed September 10, 2008, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is an overpayment in income tax due to the petitioners for the taxable year ended September 30, 1993, in the amount of $335,767.00, which amount was paid on December 15, 1993, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(b)(2), on April 6, 2000, the date of the mailing of the notice of deficiency;

That there is an overpayment in income tax for the taxable year ended September 30, 1994, in the amount of $7,153,576.00, which amount was paid on December 15, 1994, and for which amount a claim for refund could have been filed, under the provisions of

I.R.C. § 6511(b)(2), on April 6, 2000, the date of the mailing of the notice of deficiency; and

That there is an overpayment in income tax for the taxable year ended September 30, 1995, in the amount of $7,678,096.00, which amount was paid on December 15, 1995, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(b)(2), on April 6, 2000, the date of the mailing of the notice of deficiency.

(signed) ARTHUR L. NIMS, III
Arthur L. Nims, III
Judge.

Entered: Dec. 18, 2008

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Date: 11/13/2008

APPENDIX C

TITLE 26, UNITED STATES CODE

§162(k) Stock reacquisition expenses. –

(1) In general. – Except as provided in paragraph (2), no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption. of its stock.

(2) Exceptions. – Paragraph (1) shall not apply to –

(A) Certain specific deductions. – Any –

(i) deduction allowable under section 163 (relating to interest),

(ii) deduction for dividends paid (within the meaning of section 561).

(B) Stock of certain regulated investment companies. – Any amount paid or incurred in connection with the redemption of any stock in a regulated investment company which issues only stock which is redeemable upon the demand of the shareholder.

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§ 316. Dividend defined

(a) General rule. – For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders –

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of, the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

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§404(k) Deduction for dividends paid on certain employer securities. –

(1) General rule. – In the case of a corporation, there shall be allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation with respect to applicable employer securities. Such deduction shall be in addition to the deductions allowed under subsection (a).

(2) **Applicable dividend.** – For purposes of this subsection –

(A) **In general.** – The term "applicable dividend" means any dividend which, in accordance with the plan provisions –

(i) is paid in cash to the participants in the plan or their beneficiaries,

(ii) is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid, or

(iii) is used to make payments on a loan described in subsection (a)(9) the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

(B) **Limitation on certain dividends.** – A dividend described in subparagraph (A)(iii) which is paid with respect to any employer security which is allocated to a participant shall not be treated as an applicable dividend unless the plan provides that employer securities with a fair market value of not less than the amount of such dividend are allocated to such participant for the year which (but for subparagraph (A)) such dividend would have been allocated to such participant.

(3) **Applicable employer securities.** – For purposes of this subsection, the term "applicable employer securities" means, with respect to any dividend,

employer securities which are held on the record date for such dividend by an employee stock ownership plan which is maintained by –

(A) the corporation paying such dividend, or

(B) any other corporation which is a member of a controlled group of corporations (within the meaning of section 409(1)(4)) which includes such corporation.

(4) Time for deduction. –

(A) In general. – The deduction under paragraph (1) shall be allowable in the taxable year of the corporation in which the dividend is paid or distributed to a participant or his beneficiary.

(B) Reinvestment dividends. – In the case of an applicable dividend described in clause (iii) of paragraph (2)(A), the deduction under paragraph (1) shall be allowable in the taxable year of the corporation in which such dividend is used to repay the loan described in such clause.

(5) Other rules. – For purposes of this subsection –

(A) Disallowance of deduction. – The Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation.

(B) Plan qualification. – A plan shall not be treated as violating the requirements of section 401, 409, or 4975(e)(7), or as engaging in a prohibited transaction for purposes of section 4975(d)(3), merely

by reason of any payment or distribution described in paragraph (2)(A).

(6) Definitions. – For purposes of this subsection –

(A) Employer securities. – The term "employer securities" has the meaning given such term by section 409(1).

(B) Employee stock ownership plan. – The term "employee stock ownership plan" has the meaning given such term by section 4975(e)(7). Such term includes a tax credit employee stock ownership plan (as defined in section 409).

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§ 561. Definition of deduction for dividends paid

(a) General rule. – The deduction for dividends paid shall be the sum of –

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) Special rules applicable. – In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable. in determining dividends eligible for dividends paid deduction)

and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

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§ 562. Rules applicable in determining dividends eligible for dividends paid deduction

(a) General rule. – For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

* * *

(c) Preferential dividends. – The amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. In the case of a distribution by a regulated investment company to a shareholder who made an initial investment of at least $10,000,000 in such company, such distribution shall not be treated as not being pro rata or as being preferential solely by reason of an increase in the distribution by reason of reductions in administrative expenses of the company.

* * *

APPENDIX D

United States Court of Appeals
FOR THE EIGHTH CIRCUIT

No. 08-1638

General Mills, Inc. & Subsidiaries, Plaintiff-Appellee, v. United States of America, Defendant-Appellant.	* * * * * * * * *	Appeal from the United States District Court for the District of Minnesota.

Submitted: November 14, 2008
Filed: January 26, 2009

Before WOLLMAN, BEAM, and BENTON, Circuit Judges.

BENTON, Circuit Judge.

General Mills, Inc. ("GMI") sued for refunds of corporate income tax. The district court granted GMI summary judgment. The government appeals. Having jurisdiction under 28 U.S.C. § 1291, this court reverses and remands.

I.

GMI established three employee stock ownership plans ("ESOPs"). *See* **26 U.S.C. §§ 401(a), 401(k), 4975(e)(7)**. A single trust held the ESOPs' assets, primarily GMI common stock. GMI contributed to the ESOPs for the benefit of participating employees. GMI claimed deductions for payments of principal and interest on the Trust's purchase of GMI stock (financed by outside lenders). *See* **26 U.S.C. § 404(a)(9), (k)(1), (k)(2)(A)(iv)**. These deductions, totaling over $77 million, are not at issue.

When a participant left GMI, the Trust distributed, in cash or stock, the value of the participant's ESOP account. If a participant elected cash, the Trust could request that GMI purchase company stock from the Trust, paying the Trust a dividend (a "redemptive dividend"). From the redemptive dividend, the Trust could distribute to the participant a "cash distribution redemptive dividend" as part of the total cash distributed to a participant.

Tax Year	Redemptive Dividends[1]	Cash Distribution Redemptive Dividends	Total Cash Distributions To Participants
1992	$ 1,436,174	$ 1,280,358	$ 1,360,959
1993	$ 1,020,426	$ 1,176,241	$ 2,670,106

[1] There is no dispute that GMI's redemptive dividends are essentially equivalent to dividends under 26 U.S.C. § 302(b)(1) and are treated as dividends under 26 U.S.C. §§ 301, 316.

1994	$ 4,107,588	$ 2,542,502	$ 3,620,110
1995	$ 2,697,636	$ 3,155,139	$ 4,667,805
1997	$ 5,570,650	$ 5,570,650	$ 5,862,158
Total	$14,832,474	$13,724,890	$18,181,138

GMI sued to recover $4,720,329, the value of deductions for the cash distribution redemptive dividends. GMI argues that 26 U.S.C. § 404(k)(1) allows a deduction for the cash distribution redemptive dividends. The government counters that 26 U.S.C. § 162(k)(1), or alternatively § 404(k)(5), bars any deduction allowed by § 404(k)(1). The district court ruled for GMI.

II.

"Summary judgment is appropriate when there are no genuine issues of material fact, and the moving party is entitled to a judgment as a matter of law." ***Bearden v. Int'l Paper Co.***, 529 F.3d 828, 831 (8th Cir. 2008), *citing* **Fed. R. Civ. P. 56(c)**. This court reviews the district court's grant of summary judgment de novo and views the evidence in the light most favorable to the nonmoving party. ***Id.*** This court also reviews de novo the district court's interpretation of statutes. ***Milavetz, Gallop & Milavetz, P.A. v. United States***, 541 F.3d 785, 791 (8th Cir. 2008).

A.

Section 404(k)(1) allows as "a deduction for a taxable year the amount of any applicable dividend

paid in cash by such corporation with respect to applicable employer securities." **26 U.S.C. § 404(k)(1)**. An "applicable dividend" includes "any dividend which, in accordance with the plan provisions – . . . is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid." **26 U.S.C. § 404(k)(2)(A)(ii)**. The deduction may be claimed only for the tax year when the participant receives cash. **26 U.S.C. § 404(k)(4)**.

GMI's payments to participants, routed through the Trust, are "applicable dividends" under § 404(k)(2)(A)(ii). GMI, not the Trust, is the entity ("such corporation") claiming the § 404(k)(1) deduction. GMI's payment of the redemptive dividend to the Trust does not by itself qualify for a § 404(k)(1) deduction (nor does an independently-funded cash distribution by the Trust to a participant). The § 404(k)(2)(A)(ii) transaction is a two-step process.

B.

The issue is whether 26 U.S.C. § 162(k)(1) – enacted two years later – bars the deduction allowed by § 404(k)(1). "Except as provided in paragraph (2), no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of

its stock." **26 U.S.C. § 162(k)(1) (1994)**.[2] The parties agree that no exception in paragraph (2) applies. The parties stipulate that the redemptive dividends are payments for GMI's redemption of Trust-held company stock.

1.

The district court ruled that § 162(k)(1) does not bar the § 404(k)(1) deduction. Noting that § 162(k)(1) applies to a deduction that is "otherwise allowable," the district court reasoned that § 404(k)(1) does not allow a deduction for a redemptive dividend alone, but only for that portion of the redemptive dividend distributed in cash to participants. Accordingly, when applying § 162(k)(1), the court focused exclusively on the cash distribution redemptive dividend, not the two-step applicable dividend defined in § 404(k)(2)(A)(ii).

The district court then considered whether the cash distribution redemptive dividend was "in connection with" GMI's stock redemption. Citing a Ninth Circuit decision and legislative history, the court concluded that the phrase "in connection with" should

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[2] In 1996, Congress amended § 162(k)(1), *replacing* "the redemption of its stock" *with* "the reacquisition of its stock or of the stock of any related person (as defined in section 465(b)(3)(C))." *See* **Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1704(p)(1), 110 Stat. 1755, 1886 (1996)**. The parties agree that the amendment has no bearing on this case.

be construed narrowly. *See* ***Boise Cascade Corp. v. United States,*** 329 F.3d 751, 758 (9th Cir. 2003); **H.R. Rep. No. 99-841, at 168-69 (1986) (Conf. Rep.), 1986 U.S.C.C.A.N. 4075, 4256-57**. Quoting the Ninth Circuit, the court held that § 162(k)(1) bars deductions only for "fees and other expenditures 'necessary and incident' to repurchase which would otherwise be deductible business expenses." Since the Trust had an independent duty to pay participants (although it distributed nearly all the redemptive dividends to participants), the court concluded that the cash distribution redemptive dividends were not "in connection with" GMI's stock redemption, and thus § 162(k)(1) does not apply.

2.

The district court failed to recognize that the "deduction otherwise allowable" – barred by § 162(k)(1) – is the deduction for the "applicable dividend" defined in § 404(k)(2)(A)(ii). Three possible interpretations of "applicable dividend" are proposed: (1) the redemptive dividend in isolation; (2) the cash distribution redemptive dividend in isolation; and, (3) the redemptive dividend combined with the cash distribution redemptive dividend.

The third interpretation is correct. Section 404(k)(2)(A)(ii) defines an "applicable dividend" as two connected steps, the redemptive dividend (step 1) *and* the cash distribution redemptive dividend (step

2). Neither step alone is sufficient, and thus neither is an "applicable dividend" deductible under § 404(k)(1).

In this case, the "deduction otherwise allowable" is the deduction allowed by § 404(k)(1) for the applicable dividend defined in § 404(k)(2)(A)(ii). GMI acknowledges that its first step, the redemptive dividend, is "in connection with" a stock redemption. Both steps are therefore "in connection with" the stock redemption. Section 162(k)(1) bars GMI's deduction.

This court disagrees with the Ninth Circuit's analysis in the *Boise Cascade* case, which concluded that § 162(k)(1) did not bar a § 404(k)(1) deduction. ***Boise Cascade,*** 329 F.3d at 756. *See* ***North Am. Life and Cas. Co. v. Comm'r,*** 533 F.2d 1046, 1051 (8th Cir. 1976) ("decisions of other courts of appeals in the area of taxation" may be rejected if there are "cogent reasons for not following them"). That court viewed the redemptive dividend and the cash distribution redemptive dividend as "two segregable transactions," "not ineluctably linked," and "entirely separate." ***Boise Cascade,*** 329 F.3d at 757. That court emphasized that the Trustee's duty to pay the participant was not contingent on the company's payment to the Trustee for the redeemed stock. ***Id.*** at 758. The Ninth Circuit ruled that the isolated cash distribution redemptive dividend was not "in connection with" the company's stock redemption, and thus § 162(k)(1) did not bar the deduction.

As indicated above, Congress in § 404(k)(1) and § 404(k)(2)(A)(ii) connects the two steps, the redemptive dividend and the cash distribution redemptive dividend. This court cannot rule that one step is "in connection with" the stock redemption, while the other step is not. In this circuit, the phrase "in connection with" in a tax code setting is broadly construed. ***Huntsman v. Comm'r,*** 905 F.2d 1182, 1184-85 (8th Cir. 1990), *citing* ***Snow v. Comm'r,*** 416 U.S. 500, 502-03 (1974); ***Ralston Purina Co. v. Comm'r,*** 131 T.C. No. 4, 2008 WL 4159698 (2008) (citing *Huntsman* and applying § 162(k)(1) to the two connected steps of a § 404(k)(2)(A)(ii) applicable dividend).

The Ninth Circuit rejected a broad construction after extensive discussion of the 1986 legislative history of § 162(k)(1). To the contrary, the Conference Report states that "the phrase 'in connection with [a] redemption' is intended to be construed broadly." **H.R. Rep. No. 99-841, at 168 (1986) (Conf. Rep.), 1986 U.S.C.C.A.N. 4075, 4256**. The House and Senate Reports each explains that while Congress enacted § 162(k)(1) in response to corporate taxation strategies in takeover bids, "[t]his provision is not limited to hostile takeover situations but applies to any corporate stock redemption." **S. Rep. 99-313, at 223 (1986); H.R. Rep. 99-426, at 249 n.15 (1985)**. True, the Conference Report states that § 162(k)(1) does not reach "a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances." Here,

§ 404(k)(2)(A)(ii) creates a nexus between the cash distribution redemptive dividend and the stock redemption.

Further, contrary to *Boise Cascade,* the legislative history does not say that Congress intended § 162(k)(1) to bar deductions only for expenditures "necessary and incident" to stock redemptions. ***Boise Cascade,*** 329 F.3d at 758. As the Senate and House Reports both explain:

> The committee intends that amounts subject to this provision [§ 162(k)(1)] will include amounts paid to repurchase stock; premiums paid for stock; legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with repurchase; and any other expenditure that is necessary or incident to repurchase, whether representing costs incurred by the purchasing corporation or by the selling shareholder (and paid or reimbursed by the purchasing corporation), or incurred by persons or entities related to either.

S. Rep. 99-313, at 223 (1986); H.R. Rep. 99-246, at 249 (1985). The legislative history restates the clear rule that § 162(k)(1) disallows "amounts paid to repurchase stock," and in addition, all other necessary or incidental expenses.

Finally, GMI contends that "the parties' Stipulation requires that the two transactions be respected as factually separate." GMI highlights these facts:

- GMI was not required always to redeem Trust-held stock, and there were instances when the Trust sold GMI stock on the open market (although this was not in the Trust's best interest).
- The Trust had an independent duty to pay participants even if GMI did not redeem stock.
- The Trust did not always use the redemptive dividends to make cash distributions to participants.

These facts are irrelevant, as the other payments are not at issue here and the Trust's duty does not disconnect the two steps required for the deduction. GMI seeks a deduction for § 404(k)(2)(A)(ii) applicable dividends that are "in connection with" the redemption of stock. In sum, while § 404(k)(1) allows a deduction, § 162(k)(1) bars it.

III.

The judgment of the district court is reversed, and the case remanded.
